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Alert

Recent Developments in Executive Compensation

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There have been several relatively minor, yet notable, developments affecting executive compensation this year. This *Alert* provides an overview of the current executive compensation landscape.

Treatment of Partners Employed by a Disregarded Entity
In May, the Internal Revenue Service ("IRS") issued temporary regulations clarifying that an individual cannot be both a partner of a partnership as well as an employee of the partnership's subsidiary if that subsidiary is a tax disregarded entity (i.e., an entity that is essentially ignored for tax purposes). For example, if an individual employed by a disregarded entity is granted a profits interest in the disregarded entity's parent, the individual must be considered a partner.

The consequence of being a partner instead of an employee is significant. Among the differences:

- Amounts received by a partner for services are not subject to federal income tax withholding; instead, the partner is responsible for the payment of his or her taxes.
- Instead of FICA (Social Security and Medicare taxes), which generally is split evenly between an employee and employer, a partner is solely responsible for the payment of self-employment taxes (SECA), which parallels FICA.
- A partner is exempt from federal unemployment taxes and is not eligible to make a claim for unemployment benefits.
- A partner can participate in employer group health plans but must pay premiums with after-tax dollars. Partners may not participate in cafeteria plans.

The regulations are effective Aug. 1, 2016 or, if later, the first day of any affected employee benefit plan's plan year beginning after May 4, 2016.

Elimination of Filing Second Code Section 83(b) Election
Section 83(b) of the Internal Revenue Code of 1986, as amended ("Code"), allows a recipient of unvested equity, such as stock or a partnership interest, to elect to be taxed on the value of the equity on the grant date rather than the vesting date. The election must be filed with the IRS within 30 days of grant. In late July, the IRS issued final regulations that eliminate the requirement that a copy of the Code Section 83(b) election be filed with the recipient's tax return for any unvested equity granted on or after Jan. 1, 2016.

Proposed Regulations Under Code Section 409A

In June, the IRS issued proposed regulations regarding deferred compensation under Code Section 409A. The guidance, which may be relied upon immediately, is not particularly surprising but does provide useful certainty. The proposed regulations include the following:

- Upon an involuntary termination, severance pay equal to the lesser of two times the employee's compensation for the preceding year or $265,000 (as adjusted for inflation) is exempt from Code Section 409A. The proposed regulation clarifies that an employee who incurs an involuntary separation from service in the same year that he or she was hired will be eligible for this exemption based on his or her annualized compensation for the year of termination.
- Reimbursement by an employer for legal fees incurred in connection with a *bona fide* employment dispute against the employer is exempt from Code Section 409A.
- An employer's obligation to repurchase stock at a price less than fair market value (and not fair market value) is exempt from Code Section 409A if the repurchase obligation is only triggered by an involuntary separation from service or the occurrence of a condition within the employee's control (such as a breach of a restrictive covenant).
- Stock rights granted to an employee before he or she starts work can be exempt from Code Section 409A if the employee is expected to, and actually does, start work within 12 months of the grant date.
- If a change in control due to a sale of company stock is treated as an asset sale for tax purposes, an employee will not have a separation from service if the employee's employment relationship with the company otherwise continues.
- If a beneficiary becomes eligible to receive deferred compensation due to an employee's death, payment may be accelerated due to the beneficiary's death, disability or unforeseeable emergency.
- Accelerated payment of any deferred compensation is permitted to comply with *bona fide* foreign ethics or conflicts of interest laws and federal debt collection laws.
- Accelerated payment of deferred compensation in connection with the termination and liquidation of a deferred compensation plan (outside of a change in control) is only permitted if the employer terminates and liquidates all plans of the same type (e.g., voluntary elective deferred compensation, employer-mandated deferred compensation, excess benefit plans, SERPs, discounted options) and not only the type in which the employee participates. The proposed regulation clarifies that for three years after such termination and liquidation, the employer may not adopt a new plan of the same type, regardless of which employees participate.
- Deferred compensation payable upon death may be paid at the beneficiary's discretion at any time prior to the end of the calendar year following the employee's death.
- A "payment" will be deemed made upon the employee's actual receipt or constructive receipt of the compensation (generally, when the amount is made available to an employee or set aside outside the reach of the employer's creditors for the benefit of the employee, and as a result, becomes taxable to the employee).

- A payment of unvested equity to an employee will be considered a payment of deferred compensation if the employee makes a Code Section 83(b) election.
- Deferred compensation may still be exempt from Code Section 409A as a short-term deferral (generally, where payment may be made no later than the 15th day of the third month following the year in which the compensation vests) if payment is delayed to avoid violating federal securities or other applicable law.
- Deferred compensation arrangements can be subject to both Code Section 409A and the special deferred compensation requirements of Code Section 457A applicable to deferred compensation arrangements sponsored by "nonqualified entities" (i.e., partnerships with material ownership by tax indifferent partners and certain foreign corporations not subject to a comprehensive income tax).
- Entities (such as a corporation or a partnership), in addition to individuals, can be subject to Code Section 409A.

NASDAQ's 'Golden Leash' Rule

In July, the Securities and Exchange Commission approved a new rule requiring each NASDAQ-listed company to publicly disclose the material terms of all compensation arrangements between third parties and the company's directors or director nominees relating to candidacy for, or service on, the company's board. Starting on Aug. 1, 2016, these arrangements, commonly known as "golden leash" arrangements, must be disclosed on the company's website or proxy statement by the next annual shareholder meeting, and must continue to be disclosed at least once a year until the earlier of the director's resignation or one year following the termination of the golden leash arrangement. A company is not required to disclose an arrangement that provides only for reimbursement of expenses, predates a nominee's candidacy if the nominee's relationship with the third party has been disclosed in an annual report or proxy statement or has been disclosed in a Form 8-K in the current fiscal year.

Accounting for Equity-Based Payments

Earlier this year, the Financial Accounting Standards Board ("FASB") made several updates to the accounting standards for equity-based payments to employees. Among the changes, FASB simplified the rules when an employer uses a net settlement feature to withhold equity to meet an employer's tax withholding requirements. Prior to the update, GAAP required an award to be classified and accounted for as a liability if an amount in excess of the employer's minimum statutory tax withholding requirements was withheld or could be withheld at the employee's discretion. As a result of FASB's update, an award will not be classified and accounted for as a liability if the amount withheld or the amount that may be withheld at the employee's discretion does not exceed the applicable maximum statutory tax rate. Since most equity plans are now drafted to reflect the prior rule, companies that adopt the update should review their equity plans for amendments necessary to reflect the update.

Dodd-Frank Update

The Dodd-Frank Wall Street Reform and Consumer Protection Act imposes restrictions on incentive-based compensation for employees of financial institutions, including banks, registered broker-dealers and investment advisers. Proposed regulations were initially issued in 2011 and new proposed regulations were issued in April. The regulations include rules for the required deferral of payment, downward adjustment, forfeiture and clawback of incentive compensation payable to senior executive officers and significant risk-takers (generally, a non-senior executive officer that is in the position to

expose an institution to material financial harm). The regulations cover incentive compensation payable by any financial institution with over $1 billion in assets, with enhanced requirements for institutions with over $50 billion in assets and those with over $25 billion in assets. Required compliance will commence in the first calendar quarter that begins at least 540 days after the final rule is published in the Federal Register.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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